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FEDERAL COMMUNICATIONS COMMISSION
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	

COMMENTS
OF
THE LINCOLN TELEPHONE AND TELEGRAPH COMPANY

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EXECUTIVE SUMMARY

Price cap regulation as adopted for Local Exchange Companies (LECs) is an enormous improvement over rate of return regulation and the Commission now faces the challenge of taking the telecommunications industry into the next century. Technological advances, changes in the regulatory environment and increased customer knowledge have made competition a reality and the LECs are now positioned to flow the benefits of competition to all customers.

Competitive access providers can compete with the LECs, this is particularly true with smaller LECs. Lincoln believes now is the time for the Commission to reduce the wide regulatory disparity between LECs and their competitors. LECs need to be able to match competitive offerings and should not be subject to lower pricing limits. Otherwise, the LECs will be put at a significant competitive disadvantage as they seek market new and existing services.

In this regard, Lincoln urges the Commission to establish a productivity offset that realistically reflects LEC long run productivity. LEC long run productivity can be directly measured through an analysis of total factor productivity. The results of a total factor productivity study performed by Christensen Associates indicate that a productivity factor of 1.7% should be selected by the Commission.

Lincoln also urges the Commission to eliminate sharing so that price cap LECs are provided proper incentive to invest in the regulated network. Sharing places an artificial cap on earnings, distorting the risk/reward balance inherent in any market. This will clearly reduce a LECs ability to generate capital.

Finally, Lincoln strongly supports the comments of USTA that are being filed in this proceeding.

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**COMMENTS
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THE LINCOLN TELEPHONE AND TELEGRAPH COMPANY**

The Lincoln Telephone and Telegraph Company ("Lincoln"), by its attorneys, hereby submits its comments in response to the Notice of Proposed Rulemaking[1] in the above-captioned proceeding. In addition, Lincoln strongly supports the comments filed today by the United States Telephone Association ("USTA") in this proceeding.

I. INTRODUCTION

In this rulemaking the Commission is seeking comments on whether the price cap plans should be revised to better serve the goals of the Communications Act and the public interest in the years ahead. Lincoln commends the Commission for recognizing that rate of return regulation is wholly inappropriate in the competitive business climate faced today by the price cap local

1 Price Cap Performance Review for Local Exchange Carriers, Notice of Proposed Rulemaking, CC Docket No. 94-1, FCC 94-10, released February 16, 1994. ("Notice")

exchange carriers ("LECs").[2] Price cap regulation is an enormous improvement over rate of return regulation for both the LECs and their customers. Now the Commission faces the challenge of refining the current LEC price cap plan to take the telecommunications industry into the next century. Technological advancements have rapidly expanded the service options available to customers. As a result, customers are becoming increasingly more sophisticated and knowledgeable in the use of telecommunication services. These facts, coupled with a fundamental change in the regulatory environment, have made competition a reality. Competitors are entering LEC markets and offering services to high volume customers primarily located in dense urban areas. However, unlike many competitors that choose to serve only a few select customers, LECs serve all customers. Therefore, LECs are best situated to allow all customers to receive the competitive benefits of lower prices and new advanced telecommunications services. The current LEC price cap plan was a step in that direction and now Lincoln urges the Commission to adopt a price cap plan that will promote fair competition and the availability of advanced telecommunication services to all Americans[3].

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2 Notice at 4.

3 Lincoln believes that most aspects of price cap regulation requiring modification have bearing on the details in the Notice. Therefore, Lincoln responds to General Issue 1 throughout these comments. See Notice at 14.

Any revised price cap plan, at a minimum, should incorporate the following three principles. First, if the benefits of competition are to be made available to all customers, LECs must be allowed to effectively and fairly compete in the marketplace. Secondly, a productivity offset (or X factor) that realistically measures long run LEC productivity and accounts for the changes taking place in LEC markets should be selected. This productivity offset will determine if price caps will be a viable alternative for the majority of LECs and will have a significant impact on the ability of LECs, particularly mid-size and small LECs, to raise capital from both internal and external sources. Third, sharing must be eliminated so that the necessary incentives are provided for investment of scarce capital resources into the network. The elimination of sharing will allow the Commission to set LEC depreciation rates based on economic lives and allow LECs to help build a National Information Infrastructure ("NII"). Absent these adjustments Lincoln may be forced to seek to re-enter rate of return regulation in order to generate the funds needed to make advanced telecommunications services widely available to customers and satisfy investor requirements.

Lincoln feels that the Commission inappropriately believes that competitive access providers ("CAPs") are small, based upon reported revenues and fiber optic cable miles[4]. The Commission notes that the three largest CAPs had less than $500

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[4] Notice at 8.

million of access revenues in 1992[5]. This is more than 3 times Lincoln's total operating revenue. LECs with this amount of revenue are subject to an enormous regulatory burden and would probably be considered Tier 1 carriers, while CAPS are subject to very little regulation. This further demonstrates that CAPs have a much larger revenue base to generate capital than do smaller LECs such as Lincoln. Also, CAPs can enter highly dense markets with a minimal investment in fiber optic cable facilities. This investment can result in a substantial reduction of a LEC's revenue. Smaller LECs such as Lincoln are particularly vulnerable because they only operate in one metropolitan area. In addition, the majority of LEC fiber miles are located outside of the highly dense urban areas that CAPs choose to serve[6]. The Commission should not compare CAP investment in select highly profitable areas to the investment LECs make in rural infrastructure in order to determine the ability of CAPs to compete. Another factor for the Commission to consider is that CAP networks are mostly digital and comprised of fiber optic cable, while past depreciation policies have left the LECs with some older technologies such as analog switching and copper wire facilities[7].

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5 <u>Notice</u> at n. 15.

6 Less than 2.5% of Lincoln's fiber optic cable miles are located in urban areas.

7 Lincoln is not commenting on the appropriateness of depreciation policies in the rate of return environment but merely pointing out a problem in the transition to competitive markets.

II. FAIR REGULATION

The current regulatory system places LECs at a severe competitive disadvantage and denies the benefits of competition to all customers. LECs are disadvantaged by long notice periods, extensive cost support requirements, the need for Part 69 waivers to offer new services and the preclusion from matching competitive service offerings[8]. These requirements discourage customers from taking LEC services and place an enormous regulatory burden on the LECs. Competitors are allowed to review LEC service offerings and then bring like services to the marketplace while LECs are mired in the regulatory approval process.

It is inappropriate for regulation to award business to certain parties, without consideration of whether they are the most efficient producer, for the sole purpose of fostering competition. Rather the marketplace should be relied on to decide which firm is the most efficient producer. Price cap LECs are also restricted by the lower pricing limits placed on most categories of service. In this environment competitors do not need to be efficient, they only need to price below the restricted price of the LEC. It is noted by economist John Wenders that:

> "The purpose of competition is to provide goods and services at the lowest possible price. Monopoly power is the power to restrict output and raise price. Any public policy, antitrust or regulatory, that ignores these simple facts and infers some kind of monopoly power and loss in economic welfare from a policy of

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[8] This includes term, volume, contract, and ICB pricing and bundling of services and equipment.

> lower prices turns the whole basis of public-policy support for competition on its head."[9]

Thus, the only constraint needed on LEC prices is an upper limit or price cap. The Commission itself stated that service categories were designed to prevent LECs from disadvantaging one class of ratepayers to the benefit of another class[10]. The Commission only needs to retain the existing upper pricing limits on service categories to prevent LECs from disadvantaging classes of customers. Therefore, there is no economic or public policy reason to retain the lower pricing limits on service categories. Lower pricing limits serve only to deny the benefits of lower prices to customers and give competitors an artificial and unfair advantage.

Furthermore, market share should not be used to determine the degree of regulation of a market. Regulation should instead be based upon the barriers for competition to enter a market[11]. The very possibility of competition is a substantial restraint to monopoly pricing and practices[12]. The Commission has removed many barriers to competition with its recent decisions in such

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9 "The Economics of Telecommunications, Theory and Practice" ("Wenders Study"), John T. Wenders, University of Idaho, Published 1987 by Ballinger Publishing Company, Cambridge, Massachusetts at page 212.

10 Policy and Rules Concerning Rates for Dominant Carrier, Second Report and Order ("Price Cap Order"), CC Docket No. 87-313, 5 FCC Rcd 6786, 6801 (1990) at para 198.

11 Wenders Study at 206.

12 Wenders Study at 207.

proceedings as expanded interconnection[13], local transport restructure[14] and personal communications systems[15]. Technological advancements in such areas as fiber optic transmission and wireless services have removed the majority of the remaining barriers. Thus, there is no basis to continue to maintain the wide disparity in regulation between the LECs and their competitors. The adoption of a regulatory scheme that takes into account the realities of the marketplace and narrows the regulatory chasm will provide a much larger benefit to the economy than does the current asymmetrical regulatory scheme[16].

III. PRODUCTIVITY FACTOR

The Commission seeks comments on whether the productivity factor should be changed and indicates a belief that it may need to be increased[17]. The facts of the matter do not support an increase in the productivity factor and actually indicate that a decrease is warranted. The assumption that an increase in the productivity

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13 See Expanded Interconnection with Local Telephone Company Facilities, CC Docket No. 91-141.

14 See Transport Rate Structure and Pricing, CC Docket No. 91-213.

15 See Amendment of the Commission's Rules to Establish New Narrowband Personal Communication Services, GEN Docket No. 90-314.

16 This is in response to General Issue 1 and Baseline Issues 1a, 1b and 9b. See Notice at 14-15.

17 Notice at 20.

factor is needed relies on the fact that LEC earnings have increased under price cap regulation. The increase in price cap LEC earnings has been modest at best, from 11.25% in 1989 to an average of 12.25% in 1992[18]. Furthermore, price cap regulation was designed to reward LECs that increased productivity with higher earnings. It is cause for concern that the Commission can now look at the modest earnings gains experienced by price cap LECs and believe that an increase in the productivity factor is needed. This would only serve to penalize LECs for acting in accordance with the intent of price cap regulation. Any increase in the productivity factor based on increased earnings would simply recapture productivity gains achieved by LECs and undercut the very incentives that price cap regulation seeks to create.

Furthermore, the Commission should not analyze productivity based on short term historical results. Any adjustments based solely upon the short period of time that price caps have been in effect would be based erroneously on the assumption that LECs would be able to sustain or even increase productivity gains observed in the near term. Productivity gains caused by one-time events clearly cannot be sustained indefinitely and are not indicative of a change in long term productivity. There is no basis to believe that productivity gains experienced by price cap LECs can be sustained into the future. In fact, a forward looking analysis would reveal that sources of LEC

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[18] Notice at 19-20.

productivity are being substantially reduced by competition and expansion of the availability of broadband services. Also the economy is cyclical, therefore in the short term, results will usually differ from a long term industry average. A correct and fair productivity factor would be forward looking and based on analysis of LEC long term total factor productivity. Lincoln strongly supports the findings of the study performed for USTA by Christensen Associates ("Christensen Study") that indicates that the current productivity factor is too high and should be reduced to 1.7 percent.

Smaller LECs, such as Lincoln, simply cannot sustain a higher level of productivity than has been achieved historically. Competitive pressures will erode any additional productive gains that can be achieved. Smaller LECs usually operate in only one metropolitan area, and therefore are more vulnerable to competition and have fewer economies of scale. The adoption of an excessive productivity factor would preclude many carriers from ever electing price caps and may even make price caps untenable for Lincoln. A Commission selection of a productivity offset 1.7 percent coupled with the elimination of sharing would maintain price caps as a viable form of regulation for the majority of LECs. Lincoln urges the Commission not to penalize LECs based on short term results but to take a forward looking long term view of productivity with the smaller LECs in mind[19].

The Commission is also seeking comment regarding a one-time reduction in price cap LEC rates to reflect lower interest rates and a mechanism to adjust the price cap plan in the future for changes in interest rates. This is inconsistent with the Commission statement that it had moved from traditional rate of return regulation to price cap regulation[20]. This implies that there is no tie between rate of return regulation and price cap regulation. An explicit rate adjustment based upon a change in interest rates is part of traditional rate of return regulation, but has no place in price cap regulation. Also, interest rates have already indirectly influenced price cap rates through their effect upon the GNP-PI that is incorporated in the price cap plan. Therefore, an adjustment to price cap rates to reflect lower interest rates would "double count" at least some portion of the lower interest rates already reflected in the GNP-PI. In addition, interest rate changes are similar to tax rate changes which the Commission determined to be endogenous. Since no rate adjustments are allowed for tax rate changes, the price cap rules would seem to

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19 This is in response to Baseline Issues 3a and 3b. <u>See</u> <u>Notice</u> at 20.

20 <u>Notice</u> at 4.

exclude interest rate changes from adjusting price cap rates as well.[21]

IV. SHARING

Lincoln strongly urges the Commission to eliminate sharing. Regardless of its intended purpose, sharing is a tie to rate of return regulation and is not appropriate in price cap regulation. Sharing corrupts the incentives of price cap regulation with the disincentives of rate of return regulation. Price cap LECs will be less willing to undertake difficult and risky means to increase productivity as long as sharing continues to reduce the incentives of price cap regulation and keeps the rewards from being commensurate with the risks.

Also, the Commission has stated that the purpose of sharing and the low-end adjustment mechanism is to account for possible errors in setting the productivity factor and for the previous perceived lack of competition for access services. This was understandable given the imprecision in setting the existing productivity offset. However, now that productivity has been directly measured by the Christensen Study and competition is rapidly accelerating for access services, the need for sharing and low-end adjustment mechanism has been obviated.

Furthermore, as competition in LEC markets continue to evolve, capital resources will become increasingly scarce. Sharing

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[21] This is in response to Baseline Issue 3a.

will make it increasingly more difficult for the capital markets to justify giving LECs the funds needed to make large investments in regulated networks. Sharing places an artificial cap on returns from LEC lines of business and distorts the risk/reward balance. As LECs markets become even more risky, investors will become increasingly less willing to invest capital with the promise of only a limited return. This will in turn reduce the amount of capital that LECs can invest in new services and the development of a national information infrastructure.

LEC earnings have been reasonable under price cap regulation, exhibiting no signs of exorbitant earnings that might need to be restrained by a sharing mechanism. As discussed above, LEC earnings increased only slightly under price cap regulation from 11.25 percent in 1990 to 12.25 percent in 1992.[22] There is no indication that there is an error in the selection of a productivity offset or other aspect of the LEC price cap plan that would warrant the retention of sharing.[23]

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[22] See supra at 7. This represents an annual increase of only one third of one percent.

[23] This is in response to Baseline Issue 4b.

V. NEW SERVICES

Lincoln agrees with USTA's comments regarding the need for easier introduction of new services. New services will be the key to LEC financial health as competition continues to erode existing revenue sources. In fact, the existing new service rules hinder competition by delaying and, in some cases, preventing LECs from introducing new services. In addition to the comments in Section II, the Commission should regulate new, discretionary services the same for LECs and their competitors. Regulatory delays serve only to deny the benefits of new services to customers and give LEC competitors an enormous advantage in this vital area[24].

VI. BASKET AND BAND STRUCTURE

Lincoln supports USTA's comments to revise the basket structure to group like services together. The grouping of like services eliminates the need for service bands because the ability of LECs to disadvantage one class of customer in favor of another class has been substantially reduced. Also, as discussed in Section II above, there should be no lower pricing limits on baskets or bands[25].

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24 This is in response to Baseline Issues 8a and 8b. See Notice at 35.

25 This is in response to Baseline Issue 2. See Notice at 18.

VII. COMMON LINE ADJUSTMENT

Lincoln strongly supports the USTA position that a common line adjustment formula would double count the growth in LEC output already reflected in a TFP study, such as the Christensen Study. Lincoln urges the Commission to reconsider the use of a complex common line adjustment formula and develop other ways to recover common line costs rather than the current minutes of use basis[26].

VIII. SERVICE QUALITY

Lincoln concurs with USTA's assertion that customers continue to enjoy high service quality under price cap regulation. Therefore, the Commission should eliminate service quality reporting requirements. Access customers today are becoming increasingly more sophisticated and aware of the many service options available. If LECs do not provide them with quality service they will simply find an alternative. There is no longer a need to burden price cap LECs with service quality reporting[27].

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26 This is in response to Baseline Issues 5a, 5b, 5c and 5d. See Notice at 24.

27 This is in response to Baseline Issue 7a. See Notice at 30.

IX. TERM OF PLAN

Lincoln contends that a fair price cap plan should remain in effect for a minimum of 8 to 10 years. A shorter term plan does not allow price cap LECs to develop long term pricing and service strategies because of the regulation uncertainty. Frequent review and changes to the price cap plan undermine the incentives that price caps seek to create[28].

X. CONCLUSION

In conclusion, Lincoln commends the Commission for adopting price cap regulation for LECs and now recognizing the need to modify price caps to take the telecommunications industry into the next century. The Commission should also recognize that the CAP industry is no longer small and deserving of competitive protection. Lincoln, who is smaller than many CAPs, is placed particularly at risk in the existing regulatory environment.

Therefore, a revised price cap plan must include these three concepts. First, the Commission must allow full and fair competition for access services. LECs need to be able to match competitive service offerings with respect to term and volume discounts, contract and ICB pricing, and the bundling of services and equipment. Additionally, LECs should not be restricted by lower pricing limits. The existing upper pricing limits clearly

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[28] This is in response to Baseline Issue 11. See Notice at 38.

accomplish the Commission's stated goal of preventing one class of customer from being disadvantaged to the benefit of another class. Thus, there is no reason to retain the lower pricing limits. Also, market share is an inappropriate measure of market power. The Commission should instead rely on competition or even the threat of competition to curb monopoly practices. Second, the Commission needs to determine a fair productivity offset by analyzing LEC long term total factor productivity and the changes taking place in LEC markets. A productivity factor based on short term historical results, that are not indicative of any long term trends, would only serve to destroy the very incentives that price cap regulation seeks to create. A realistic look at future LEC productivity would indicate the adoption of a productivity offset no greater than 1.7%. Furthermore, adjusting price cap rates for changes in interest rates which is a fundamental part of rate of return regulation, is wholly inappropriate in price cap regulation. Finally, sharing has to be eliminated in order for the risk/reward ratio to come back into balance. Currently the returns in LEC access markets are not commensurate with the risks. As a result, the ability of LECs to generate the capital needed for large investments in the regulated network has been reduced. This problem will only grow worse as long as a sharing mechanism is retained in the price cap plan. Lincoln urges the Commission to recognize the inadequacies in today's regulatory environment, particularly as they relate to smaller LECs, and adopt the proposals suggested by Lincoln and USTA.

Respectfully submitted,

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May 9, 1994

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CERTIFICATE OF SERVICE

I, Robert A. Mazer, hereby certify that a copy of the foregoing document was served by first-class mail, postage prepaid, this 9th day of May, 1994 on the following persons:

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